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CITATIONS

In the Supreme Court of the United States

OCTOBER TERM, 1948

No. —

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

L. F. LONG

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in this case.

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 30-53) are not reported. The opinion of the Court of Appeals (R. 226-231) is reported at 173 F. 2d 471.

JURISDICTION

The judgment of the Court of Appeals was entered on March 17, 1949. The jurisdiction of this

Court is invoked under 28 U. S. C., Section 1254 (1).

QUESTION PRESENTED

Under Sections 181-182 of the Internal Revenue Code, a member of a partnership is taxed upon his allocable share of the income earned by the partnership; that income is treated as ordinary income or capital gain depending upon the nature of the assets to which the income is attributable.

The question here presented is whether, as the court below held, the profit received by a taxpayer who retires as a member of a partnership, transferring his interest in certain of the partnership assets to his partners who continue the business, is to be taxed as capital gain rather than as ordinary income even though the partnership assets are non-capital assets, the income attributable to which would be taxed as ordinary income if the taxpayer had continued in the partnership.

STATUTE INVOLVED

The applicable provisions of the statute involved are set forth in the Appendix, *infra*, p. 8, *et seq.*

STATEMENT

In 1940, the taxpayer was a partner in the Joe Long Drilling Company, having a one-third interest. His father, Joe Long, and his step-mother, Edith Long, were associated with him as the other partners, each possessing a one-third interest. (R. 30-31.)

The chief asset of the partnership was the Owens leasehold, which was acquired in about 1933 and

consisted of 300 acres located in Gregg County, Texas. It was divided into three different leases, known as A, B, and C leases. Later, but before October 5, 1938, the partnership acquired one-fourth of the one-eighth royalty under the Owens B lease and three-fourths of the one-eighth royalty under the Owens C lease. (R. 31.) The partners also possessed certain other tangible assets, some of which appeared to have been depreciable and others of which constituted the partners' stock in trade (R. 19-20, 38-41, 51).

On December 30, 1940, the taxpayer withdrew from the partnership. This was accomplished by the execution of four instruments which were exchanged contemporaneously. On that date, the parties executed an agreement called "Assignment of Oil and Gas Lease." It recited that the Owens leasehold was then owned by the partnership, composed of taxpayer and his father and stepmother, and that taxpayer, joined by his wife, "desires to withdraw from the partnership" and "to dispose of his One-third (1/3) interest" in the Owens leasehold, subject to the reservation of an overriding royalty interest. The agreement then went on to state that taxpayer and his wife, "the present owners of a One-third (1/3) interest in the partnership, Joe Long Drilling Company, the owner" of the Owens leasehold, conveyed to Joe Long and his wife all of their right, title and interest "now owned by them in and to the said

lease and all equipment and personal property located thereon and used in connection therewith" except "an undivided One-seventh (1/7) Overriding Royalty interest in and to the Seven-eighths (7/8) leasehold interest, which is equivalent to One-eighth (1/8) of the entire production," free and clear of all operating, equipment, and development costs, limited, however, to $334,000, and covenanted that "they are the lawful owners of said interest in said lease and rights and interests thereunder, and of the personal property thereon or used in connection therewith; that the undersigned have good right and authority to sell and convey the same * * *." (R. 36-37.)

On the same day, Joe Long and his wife, as partners of the Joe Long Drilling Company, executed an instrument called a "Mineral Deed," conveying to taxpayer all of the interest acquired by the Joe Long Drilling Company in the Owens B lease. They also executed, on the same day, a like instrument in which they conveyed to taxpayer one-sixth of the royalty interest of the Joe Long Drilling Company in the Owens C lease. The latter instrument recited that prior to its execution, the grantors and grantee together owned three-fourths of the mineral rights and that the purpose of the instrument was to vest in taxpayer a sufficient interest so that his ownership thereafter would be one-half of three-fourths of the royalty interest, and that the remaining like share would be owned in equal proportions by the grantors "who will continue operat-

ing as Joe Long Drilling Company and receive payment for production from said royalty in the name of the partnership which will hereafter be composed of Joe Long and Edith Long, each owning an undivided one-half (½) interest." (R. 37-38.)

On December 31, 1940, Joe Long and his wife, described as "two of the partners of the Joe Long Drilling Company," executed an instrument, described as a bill of sale, transferring to taxpayer (R. 38): "Our Two-thirds (2/3) interest in Drilling Tools and Drilling Equipment acquired * * * by the Joe Long Drilling Company, a partnership * * *."

The agreement reached by taxpayer with his father and step-mother resulted in the distribution to him in kind of the overriding royalty, drilling tools and equipment, consisting of a drilling rig, and the Owens B and C royalty interests, as set forth above; he also received a payment of $136,000 in cash from his father and step-mother and also a note for $30,000 signed by his father (R. 38-39).

The taxpayer reported long-term capital gain on this transaction. The Commissioner determined, in so far as the gain was attributable to the sale of non-capital assets by the taxpayer to his father and step-mother, that he was taxable as for the receipt of ordinary income. The Tax Court held that the gain was taxable as long-term capital gain. (R. 15-27, 39-41, 50-51.) The Court of Appeals affirmed (R. 227), relying on its decision in *Commissioner* v.

H. R. Smith, 173 F. 2d 470, in which a petition for a writ of certiorari is also being filed.

REASONS FOR GRANTING THE WRIT

The court below decided this issue by relying on its decision in *Commissioner* v. *H. R. Smith,* 173 F. 2d 470, in which a petition for a writ of certiorari is being filed. The reasons for granting the writ which are set forth in the petition in the *Smith* case control this case as well.

The principles contended for in the *Smith* case are applicable to the somewhat different circumstances of this case. When the taxpayer withdrew from the partnership, he received a distribution in kind of certain of the partnership assets, i. e., the reserved oil payment in the Owens leasehold, one-half of the firm's interest in the Owens C royalty, all of the firm's interest in the Owens B royalty, and a drilling rig. This distribution in kind did not result in a realization of income, taxation of the gain or loss on the property being postponed until such time as the taxpayer may dispose of it. Section 113 (a) (13), Internal Revenue Code (Appendix, *infra,* p. 8); Section 19.113 (a) (13)-2, Treasury Regulations 103, promulgated under the Internal Revenue Code. However, the taxpayer transferred to his former partners his interest in the remaining partnership assets which, being greater in value than that distributed to him, resulted in their making additional payments to him in the way of cash and cash equivalents to compen-

sate him for that difference. To that extent, the taxpayer sold his interest in those assets and the character of the gain must be determined by the nature of the assets in which an interest was sold. Some of those assets were capital assets and the Commissioner properly held that the gain attributable to them was taxable as capital gain. Other assets transferred were, however, ordinary assets and this gain should have been taxed as ordinary income. The court below erred in holding that the entire gain realized by the taxpayer resulted from the sale of a capital asset.

CONCLUSION

This petition for a writ of certiorari should be granted.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

JUNE, 1949.

APPENDIX

INTERNAL REVENUE CODE:

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(13) *Partnerships.*—If the property was acquired, after February 28, 1913, by a partnership and the basis is not otherwise determined under any other paragraph of this subsection, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. If the property was distributed in kind by a partnership to any partner, the basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property.

* * * * *

(26 U.S.C. 1940 ed., Sec. 113.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer

(whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l); * * *

* * * * *

(4) *Long-Term Capital Gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

(b) *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66 2/3 per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

* * * * *

(26 U.S.C. 1940 ed., Sec. 117.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U.S.C. 1940 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

(a) As a part of his short-term capital gains or losses, his distributive share of the net short-term capital gain or loss of the partnership.

(b) As a part of his long-term capital gains or losses, his distributive share of the net long-term capital gain or loss of the partnership.

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

(26 U.S.C. 1940 ed., Sec. 182.)

SEC. 183. COMPUTATION OF PARTNERSHIP INCOME.

(a) *General Rule.*—The net income of the partnership shall be computed in the same manner and on the same basis as in the case of

an individual, except as provided in subsections (b) and (c).

(b) *Segregation of Items.*—

(1) *Capital Gains and Losses.*—There shall be segregated the short-term capital gains and losses and the long-term capital gains and losses, and the net short-term capital gain or loss and the net long-term capital gain or loss shall be computed.

(2) *Ordinary Net Income or Loss.*—After excluding all items of either short-term or long-term capital gain or loss, there shall be computed—

(A) An ordinary net income which shall consist of the excess of the gross income over the deductions; or

(B) An ordinary net loss which shall consist of the excess of the deductions over the gross income.

(c) *Charitable Contributions.*—In computing the net income of the partnership the so-called "charitable contribution" deduction allowed by section 23 (o) shall not be allowed; but each partner shall be considered as having made payment, within his taxable year, of his distributive portion of any contribution or gift, payment of which was made by the partnership within its taxable year, of the character which would be allowed to the partnership as a deduction under such section if this subsection had not been enacted.

(26 U.S.C. 1940 ed., Sec. 183.)

Sec. 184. Credits Against Net Income.

The partner shall, for the purpose of the normal tax, be allowed as a credit against his net income, in addition to the credits allowed to him under section 25, his proportionate share of such amounts (not in excess of the net income of the partnership) of interest specified in section 25 (a) as are received by the partnership.

(26 U.S.C. 1940 ed., Sec. 184.)

Sec. 185. Earned Income.

In the case of the members of a partnership the proper part of each share of the net income which consists of earned income shall be determined under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary and shall be separately shown in the return of the partnership.

(26 U.S.C. 1940 ed., Sec. 185.)

Sec. 186. Taxes of Foreign Countries and Possessions of United States.

The amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of the member of a partnership to the extent provided in section 131.

(26 U.S.C. 1940 ed., Sec. 186.)

SEC. 187. PARTNERSHIP RETURNS.

Every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this chapter and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner with the approval of the Secretary may by regulations prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

(26 U.S.C. 1940 ed., Sec. 187.)

SEC. 188. DIFFERENT TAXABLE YEARS OF PARTNER AND PARTNERSHIP.

If the taxable year of a partner is different from that of the partnership, the inclusions with respect to the net income of the partnership, in computing the net income of the partner for his taxable year, shall be based upon the net income of the partnership for any taxable year of the partnership (whether beginning on, before, or after January 1, 1939) ending within or with the taxable year of the partner.

(26 U.S.C. 1940 ed., Sec. 188.)

Sec. 189 [As added by Section 211 (d), Revenue Act of 1939, c. 247, 53 Stat. 862]. Net Operating Losses.

The benefit of the deduction for net operating losses allowed by section 23 (s) shall not be allowed to a partnership but shall be allowed to the members of the partnership under regulations prescribed by the Commissioner with the approval of the Secretary.

(26 U.S.C. 1940 ed., Sec. 189.)

Sec. 190 [As added by Section 155 (h), Revenue Act of 1942, c. 619, 56 Stat. 798]. Allowance of Amortization Deduction.

In the case of emergency facilities of a partnership, the benefit of the deduction for amortization allowed by section 23 (t) shall not be allowed to the members of a partnership but shall be allowed to the partnership in the same manner and to the same extent as in the case of an individual.

(26 U.S.C. 1946 ed., Sec. 190.)

Sec. 3797. Definitions.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

*   *   *   *   *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which

any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * * * *

(26 U.S.C. 1940 ed., Sec. 3797.)

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